Internal Revenue Service
memorandum

CC:TL:Br2
PLBurquest-Fultz

TL-N-9523-89

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to: Regional Counsel, Midwest
Attention: Beth L. Williams, Special Trial Attorney CC:MW

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Taxability of [redacted] Stock Dividends Paid to Member Banks
Taxpayer: [redacted] Docket No. [redacted]

This memorandum responds to your August 24, 1989, request for Tax Litigation Advice in the above-referenced case. This memorandum also confirms, in writing, our oral advice to you in October, wherein we recommended concession of the [redacted] ([redacted]) stock dividend issue in the context of this case. The Tax Litigation Division has recommended abandonment of Service position on the taxability of [redacted] stock dividends and has requested revocation of Rev. Rul. 83-68, 1983-1 C.B. 75, which asserts that said dividends are taxable to the member banks under I.R.C. § 301 pursuant to section 305(b)(1). At this time, Technical is considering whether the ruling should be revoked and Service position abandoned. We will inform you of the ultimate resolution of this issue, once Service position has been finalized.

ISSUES

You have asked us to respond to the following questions.

1. Whether the redemption of [redacted] stock held by a member bank is an "isolated redemption" within the meaning of Treas. Reg. § 1.305-3(b)(3) so as to render inapplicable the provisions of sections 305(b)(2) and (c).

2. What is the effect of section 421(b) of the Tax Reform Act of 1969 on the applicability of section 305(b)(2) to this case.

3. Assuming the government proceeds with a section 305(b)(2) argument in this case, what is the proper method for applying the disproportionate interest test in these circumstances.

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CONCLUSIONS

For the reasons discussed herein, we have concluded that the government should not assert that stock dividends received by [redacted] ([redacted]) from the [redacted] in [redacted] are taxable under section 301 as disproportionate distributions under section 305(b)(2). Accordingly, we recommend concession of the [redacted] stock dividend issue in this case.

Because we have recommended concession of the stock dividend issue, it is unnecessary for us to respond specifically to issues two and three, above. If you wish further clarification of those issues in the context of a case that does not involve [redacted] stock dividends, please contact us.

FACTS

The following paragraphs briefly summarize the information submitted to us for consideration of the issues in this case. Our conclusions and recommendation in this case are based, in part, on these facts.

During tax periods ending [redacted],[1] [redacted], and [redacted], [redacted] was a member of the [redacted] in the San Francisco District (hereinafter, [redacted]). As a member, it was entitled to receive dividends from the [redacted] based on earnings of the district bank which were required to be distributed, less certain reserve requirements, each year. Historically, the [redacted] had paid cash dividends. However, for the tax periods at issue in this case, stock dividends were paid in lieu of cash dividends, totalling $[redacted], $[redacted], and $[redacted], respectively, for the periods mentioned above.

The [redacted]'s records indicate that [redacted] used some of the stock dividends to increase its holdings as required by the [redacted]'s one-percent minimum stock ownership requirement.[2]

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[1] Before its acquisition by the [redacted] consolidated group of corporations, [redacted] reported its taxable income on the basis of a fiscal year ending [redacted]. After acquisition, it changed its tax year to a calendar year. To reflect this change in taxable year, a short period return was filed for the period ending [redacted].

[2] As stated in your request for Tax Litigation Advice, 12 U.S.C. § 1426, as in effect for the years at issue, required each member bank to maintain a minimum capital stock ownership in the [redacted] equal to one-percent of the member's net home mortgage loans (continued...)

The [redacted]'s records also indicate that, during each of the years at issue, [redacted] held stock in excess of the one-percent minimum stock ownership requirement.

During [redacted] and [redacted], the [redacted] had shares outstanding which totalled approximately [redacted] and [redacted], respectively. Average holdings of member bank totaled approximately [redacted] percent ([redacted] shares) of total shares outstanding in [redacted] and approximately [redacted] percent ([redacted] shares) in [redacted]. The largest holding of any member bank was approximately [redacted] percent of total outstanding shares. This percentage of shares was held by only one member institution. We do not know the percentage of stock owned by [redacted] during the years in question; we have assumed that its ownership in the [redacted] approximated the average holdings, listed above.

Under the facts of a typical [redacted] stock dividend, member banks with shares in excess of the minimum stock ownership requirement can redeem excess shares by making a formal redemption request to the district bank in which it is a member. The redemption price is fixed at $100 per share. Redemption results in a decrease in voting rights, a decrease in future dividends (which are made on a per share basis), and a decrease in the proceeds to be received on liquidation.[3]

[redacted] did not redeem any of its [redacted] stock during the periods at issue. We do not presently know whether any other member banks redeemed stock during the pertinent time periods.

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[2](...continued) outstanding as determined on an annual basis at year end. Each member bank was also required, at all times, to hold [redacted] stock equal to at least five-percent of the advances made by the [redacted] to such member bank.

[3] Stock held by member banks is not entitled to share in the net assets of the district bank on liquidation. Instead, each share receives par value of $100 on liquidation. It appears that any remaining corporate assets revert to the [redacted], or a governmental or quasi-governmental entity. However, the redemption of shares reduces liquidation proceeds a member bank would receive.

DISCUSSION

Issue: Whether the redemption of [redacted] stock held by a member bank is an "isolated redemption" within the meaning of Treas. Reg. § 1.305-3(b)(3) so as to render inapplicable the provisions of sections 305(b)(2) and (c). Further, whether there are other exceptions to the application of sections 305(b)(2) and (c) that may be applicable under the facts of this case.

Section 305(b)(2) provides that if a distribution (or series of distributions) by a corporation of its stock has the result of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation, the distribution shall be treated as one to which section 301 applies. A redemption which is treated as a distribution to which section 301 applies may also be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by the redemption. I.R.C. § 305(c); Treas. Reg. § 1.305-7(a). The regulations provide that this deemed distribution will generally be treated as a distribution to which sections 305(b) and 301 apply. Treas. Reg. § 1.305-7(a). However, a distribution of property incident to an isolated redemption of stock will not be treated as a distribution to which section 305(b)(2) applies even if the redemption is treated as a section 301 distribution to the redeeming shareholder. Treas. Reg. § 1.305-3(b)(3).

We believe there are at least two substantial hazards to the litigation of this issue in the context of the [redacted] case under section 305(b)(2). Our conclusion that this issue should be conceded is based on the existence of two administratively created "exceptions" which would operate to eliminate the application of section 305(b)(2), referred to in this memorandum as the di minimis interest exception and the isolated redemption exception. Discussion of those exceptions follows.

a. The "Di Minimis Interest Exception" under Section 302:

As discussed above, for section 305(b)(2) to apply to a stock dividend/redemption scenario, Treas. Reg. § 1.305-3(b)(3) requires that the distribution be made to a shareholder in his capacity as a shareholder and must be a distribution to which section 301 (among other sections) applies. In determining whether a redemption is a distribution to which section 301 applies, the tests contained in section 302(b) are applied. Based on the facts of the typical [redacted] stock dividend distribution and redemption, only the test contained in section 302(b)(1) is applicable. Under that test, if a redemption is "essentially equivalent to a dividend," it will be treated as a distribution to which section 301 applies. The Supreme Court's analysis in the case of United States v. Davis, 397 U.S. 301 (1970), established the "meaningful reduction test" to determine whether or not a redemption has met the test for dividend equivalence. Administrative pronouncements under section 302(b)(1) have focused on the redemption's effect on a shareholder's right to vote and exercise control over the corporation; right to participate in corporate earnings (current or accumulated); and right to share in corporate assets upon liquidation. See e.g., Rev. Rul. 75-502, 1975-2 C.B. 111; Rev. Rul. 76-364, 1976-2 C.B. 91; and Rev. Rul. 75-512, 1975-2 C.B. 112.

The Service has ruled that a reduction of ownership from 27 percent to 22 percent was a meaningful reduction where the remaining shares of stock were owned equally by three unrelated shareholders. Rev. Rul. 76-364, 1976-2 C.B. 91. Additionally, the Service has applied a de minimis rule in holding that a redemption that decreased a shareholder's ownership from .0001118 percent to .0001081 percent in a public company was not essentially equivalent to a dividend, even though the shareholder's ownership interest decreased only 3.3 percent by the redemption. Rev. Rul. 76-385, 1976-2 C.B. 92. The ruling states:

> The redemption in the instant case falls within the category of redemptions Congress intended to exclude from dividend treatment through the enactment of section 302(b)(1) of the Code since the redemption involves a minority shareholder whose relative stock interest in [the distributing corporation] is minimal and who exercises no control over the affairs of [the corporation]. In addition, as a result of the redemption, [the shareholder] experienced a reduction of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in net assets on liquidation. Thus, under the facts and circumstances of the instant case, the redemption qualifies under section 302(b)(1).

1976-2 C.B. at 93. Although the Interpretative Division questioned Rev. Rul. 76-385's conclusion and reliance on the legislative history underlying section 302(b)(1) under a factual scenario involving a voluntary surrender of stock by common shareholders [[redacted], G.C.M. 38357, I-402-77 (April 21, 1980)], the ruling has not been revoked or obsoleted and may be relied on by taxpayers.

The facts of the typical [redacted] stock dividend/redemption situation involve minority shareholders who exercise no control over the affairs of the district bank. Furthermore, the reduction in ownership by the redemption results in a reduction of the amount of liquidation proceeds a member bank would receive. These factors, appear to bring the redemption transaction within the "di minimis rule" applied in Rev. Rul. 76-385 and within the category of redemptions Congress intended to exempt from section 302(b)(1). Thus, we believe litigation of the issue against the typical member bank in the [redacted] (i.e., a .45 percent owner), would not be successful for the government.

b. The Isolated Redemption Exception under Section 305(b)(2):

As stated in the opening paragraph of the discussion section of this memorandum, the regulations provide that even if the redemption is treated as one covered by section 301 and results in the receipt of property by some shareholders and an increase in the proportionate interest of other shareholders in the assets or earnings and profits of the corporation, section 305(b)(2) will not apply to an isolated redemption. Treas. Reg. § 1.305-3(b)(3). If the "isolated redemption" exception applies, nonredeeming shareholders, whose proportionate interests in the corporation have effectively been increased by the redemption of other shareholders, would receive a nontaxable stock dividend pursuant to section 305(a), because section 305(b)(2) would be inapplicable. The regulations provide guidance, by way of example, on the operation of the "isolated redemption" exception. Typically, redemptions meeting the "isolated redemption" exception involve redemptions which are not part of a plan for periodically redeeming the stock of the corporation. See Treas. Reg. § 1.305-3(e) (examples 11 and 13). On the other hand, elements common to redemption transactions found to give rise to taxable distributions in the regulations include a formalized plan of redemptions and an equal opportunity for shareholder participation in the redemption program. See Treas. Reg. § 1.305-3(e) (examples 8 and 9).

The Service has provided further guidance on the isolated redemption exception by revenue ruling. In Rev. Rul. 78-60, 1978-1 C.B. 81, the Service ruled that where a corporation adopted a plan of annual voluntary redemption whereby small amounts of stock were redeemed each year by shareholders who continued to own stock in the corporation, the redemption would be treated as a section 301 distribution pursuant to section 302(b)(1) because none of the redeeming shareholders realized a "meaningful reduction" in their proportionate interest in the corporation. Although the shareholders held minority interests, there is no specific discussion of the potential application of a di minimis rule such as that described in Rev. Rul. 76-385. This apparent inconsistency can be resolved by the existence of a formalized plan of voluntary annual redemptions under the facts of Rev. Rul. 78-60. With regard to the "isolated redemption" exception, the ruling states that the exception was not met based on the corporation's formal plan of voluntary annual redemptions.

We believe the existence of an "isolated redemption" exception presents a substantial litigation hazard to any case which is appealable to the Seventh Circuit. Our concerns are based on the likelihood that a court would find that there was no formalized redemption plan, but only a statutory right to request redemption which requires discretionary action on the part of the [redacted] to achieve. In Frontier Savings Association v. Commissioner, 87 T.C. 665 (1986), aff'd 854 F.2d 1001 (7th Cir. 1988), the Tax Court's finding that redemption of member banks' shares by the district bank were the result of the district bank's exercise of its discretionary authority would also support the nonexistence of a "plan" of redemption. The corporate formality of adopting a plan of redemption, such as that described in Rev. Rul. 78-60, supra, was not carried out by the [redacted]. The Tax Court's refusal to find any abdication of discretionary authority on the part of the district bank, even though no redemption requests had ever been denied, indicates that the Tax Court and the Seventh Circuit would most likely not find that a formalized plan of redemption existed, and thus, would likely find any redemptions of distributed stock to be "isolated redemptions" within the meaning of Treas. Reg. § 1.305-3(e).

RECOMMENDATION

Based on the foregoing discussion, we recommend that the Service not assert that the [redacted] stock dividends received by [redacted] were disproportionate distributions under section 305(b)(2). Although the Service has not yet officially determined what position it will take as an alternative position to Rev. Rul. 83-68, in light of the government losses in Frontier, supra, and Western Federal Savings and Loan Association v. Commissioner, T.C. Memo. 1988-197, aff'd, No. 88-2001 (8th Cir. July 27, 1987), we believe litigation of any alternative argument should be avoided in cases appealable to either the Seventh or Eighth Circuits. In the context of the [redacted] case, we believe settlement of the issue on the primary position set forth in Rev. Rul. 83-68 is not possible because of appellate venue. Furthermore, we recommend against litigation of alternative arguments at this time. Accordingly, we recommend concession of the [redacted] stock dividend issue in that case.

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